UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF INDIANA
HAMMOND DIVISION

IN RE:	)	
	)	
STEPHANIE S. SPOLARICH,	)	CASE NO. 08-23438 JPK
	)	Chapter 7
Debtor.	)	

MEMORANDUM OF DECISION IN CONTESTED MATTER

This contested matter arises from a motion for turnover filed by Kenneth A. Manning, as Trustee of the Chapter 7 bankruptcy estate of Stephanie S. Spolarich ("Trustee") on March 6, 2009, and the objection of the debtor ("Spolarich") to that motion. The motion, filed pursuant to 11 U.S.C. § 542(a), is governed by the provisions of Fed.R.Bankr.P. 9014. The court has jurisdiction pursuant to 28 U.S.C. § 1334(b); 28 U.S.C. § 157(a) and (b)(1); and N.D.Ind.L.R. 200.1(a)(1) and (2). This matter is a core proceeding under 28 U.S.C. § 157(b)(2)(E).

The factual record pertinent to the motion has been stipulated by the Trustee and Spolarich. The debtor, entitled to receive Social Security disability benefits, elected pursuant to the procedure stated in 26 U.S.C. § 3402(p), to have a portion of her 2008 benefits, payable in 2008, withheld. In 2009, the Internal Revenue Service returned $1,918.00 so withheld to Spolarich: this amount derives solely from Social Security benefits payable in 2008 with respect to which Spolarich elected the withholding designated above. Pursuant to the formula employed by Chapter 7 Trustees in this Division of the United States Bankruptcy Court, the Trustee requested turnover of $1,508.28 as the pro-rata amount of the $1,918.00 payment allocated to the pre-petition portion of 2008.[1]

The Trustee contends that the amount subject to his turnover motion should be deemed to be a "tax refund", subject only to whatever exemption the debtor may claim pursuant to I.C. 34-55-10-2(c)(3). Spolarich contends that because the derivation of the amount received from

[1] Spolarich's Chapter 7 case was filed on October 14, 2008.

the Internal Revenue Service is Social Security benefits, the entire amount is not subject to turnover by operation of 42 U.S.C. § 407(a) and case law which has construed that section.

The precise issue presented to the court is whether Social Security benefits subject to the protections of 42 U.S.C. § 407(a) lose the characterization of benefits subject to that section to the extent benefits are withheld pursuant to 26 U.S.C. § 3402(p) and are returned to the debtor by the Internal Revenue Service as a "tax refund".

Spolarich elected withholding of her Social Security benefits pursuant to 26 U.S.C. § 3402(p), which in part pertinent to the issue before the court provides:

> (p) Voluntary withholding agreements.–
>
> (1) Certain Federal payments.–
>
> (A) In general.– If, at the time a specified Federal payment is made to any person, a request by such person is in effect that such payment be subject to withholding under this chapter, then **for purposes of this chapter and so much of subtitle F as relates to this chapter**, such payment shall be treated as if it were a payment of wages by an employer to an employee.
>
> (B) Amount withheld.– The amount to be deducted and withheld under this chapter from any payment to which any request under subparagraph (A) applies shall be an amount equal to the percentage of such payment specified in such request. Such a request shall apply to any payment only if the percentage specified is 7 percent, any percentage applicable to any of the 3 lowest income brackets in the table under section 1(c), or such other percentage as is permitted under regulations prescribed by the Secretary.
>
> (C) Specified Federal payments.– For purposes of this paragraph, the term "specified Federal payment" means–
>
> (i) any payment of a social security benefit (as defined in section 86(d)), (emphasis supplied)

The foregoing statute provides that a recipient of Social Security benefits may direct withholding of a portion of those benefits by the Social Security Administration, and the retention of the part withheld by the Internal Revenue Service. It is of particular moment to note that 26 U.S.C.

§ 3402(p)(1)(A) specifically states that the effect of the request for withholding is that "for purposes of this chapter and so much of subtitle F as relates to this chapter, such payment shall be treated as if it were a payment of wages by an employer to an employee".

42 U.S.C. § 407 states in its entirety the following:

> (a) The right of any person to any future payment under this subchapter shall not be transferable or assignable, at law or in equity, and none of the moneys paid or payable or rights existing under this subchapter shall be subject to execution, levy, attachment, garnishment, or other legal process, or to the operation of any bankruptcy or insolvency law.
>
> (b) No other provision of law, enacted before, on, or after April 20, 1983, may be construed to limit, supersede, or otherwise modify the provisions of this section except to the extent that it does so by express reference to this section.
>
> (c) Nothing in this section shall be construed to prohibit withholding taxes from any benefit under this subchapter, if such withholding is done pursuant to a request made in accordance with section 3402(p)(1) of the Internal Revenue Code of 1986 26 U.S.C.A. § 3402] by the person entitled to such benefit or such person's representative payee.

It is of particular moment to note that the foregoing statute states that Social Security benefits "shall [not] be subject . . . to the operation of any bankruptcy or insolvency law".

The protection provided to Social Security benefits by 42 U.S.C. § 407(a) is exceptionally expansive. The statute protects Social Security benefits from a state statute which authorized the State of Arkansas to seize "property or 'estate' in order to defer the costs of maintaining the state's prison system"; *Bennett v. Arkansas*, 108 S.Ct. 1204 (1988). The statute protects Social Security benefits deposited into a bank account from garnishment of that account; *Philpott v. Essex County Welfare Board*, 93 S.Ct. 590 (1973). Thus, Social Security benefits are exempt from execution and other legal process pursuant to § 407(a) even after their receipt by the recipient and deposit into a bank account; *Perkins v. Kocher*, Ind. App., 531 N.E.2d 231 (1988); *Brosamer v. Mark*, Ind., 561 N.E.2d 767, 768 (fn 1), *affirming* 540 N.E.2d

652 (Ind. App. 1989). Under common law rights of setoff, a bank cannot exercise rights of setoff against a depositor's account with respect to a debt owed to the bank, with respect to Social Security benefits deposited into the account sought to be subjected to setoff; *In re Capps*, 251 B.R. 73 (Bankr. Neb. 2000). While these cases are not directly on point with respect to the issue at hand because the Social Security benefits involved in those cases were not received by the recipient in the form of a payment made by a taxing authority, the cases stand for the proposition that the protections afforded by 42 U.S.C. § 407 are extraordinarily broad. It has even been held that the provision of § 407(a) that excludes benefits from "the operation of any bankruptcy or insolvency law" is not in the nature of an exemption statute at all, but rather in a bankruptcy context excludes Social Security benefits from the concept of property of the bankruptcy estate under 11 U.S.C. § 541; *In re Carpenter*, 408 B.R. 244 (8th Cir. BAP 2009).

In the face of the expansive protection accorded to Social Security benefits by 42 U.S.C. § 407, the Trustee argues that payment received by the debtor from the Internal Revenue Service – admittedly derived exclusively from Social Security benefits – has been transformed into a tax refund outside the scope of § 407. The Trustee cites several cases in support of his argument.

The case of *Mason v. Sybinski, et al.*, 280 F.3d 788 (7th Cir. 2002), *cert. denied*, 123 S.Ct. 1384 (2003), is inapposite. In that case, the class of Social Security beneficiaries (mental health patients institutionalized in a hospital or other care facility) designated the hospital/care facility as the recipient of benefits pursuant to provisions of federal law and regulations which required that the benefits be applied "for the use and benefit" of the recipient with respect to the care provided by the institution. The Seventh Circuit Court of Appeals held that under the specific program at issue, the payment to the "representative payee" institution did not violate § 407, because in receiving the benefits, the payee did not employ "other legal process" in

contravention of § 407(a). *Mason* was decided under provisions of laws relating to payment of Social Security benefits to a third party under a specific federal program; this program is not involved in this case.

The Trustee cites *Lopez v. Washington Mutual Bank*, 302 F.3d 900 (9th Cir. 2002) in support of his contentions. In *Lopez*, the issue was whether a bank could apply Social Security benefits directly deposited into a depositor's account to cover overdrafts of the depositor with respect to that account, in a circumstance in which the agreement between the bank and the depositor allowed for setoffs of a depositor's funds against a bank's advancement of funds in an overdraft situation. The court held that this arrangement did not violate 42 U.S.C. § 407(a), because the depositor had voluntarily agreed to the setoff. There are several other cases, not cited by the parties, which stand for a similar proposition, i.e., that by entering into a voluntary agreement, a Social Security benefit recipient may waive the protections of § 407. The fallacy of the Trustee's argument is apparent in the contention, stated on the third page of his memorandum, for which he cites *Lopez*. That contention is that Spolarich has voluntarily consented "to the assignment and application of Social Security benefits". However, by electing withholding of benefits pursuant to 26 U.S.C. § 3402(p), Spolarich consented only to withholding of monies potentially subject to her federal tax liabilities; she did not consent to any "assignment or application" of those funds to a creditor or to a bankruptcy trustee. The critical failing point of the Trustee's contention is that 42 U.S.C. § 407(c) specifically authorizes the withholding directive of a Social Security recipient pursuant to 26 U.S.C. § 3402(p). The latter statute, § 3402(p)(1)(A), limits the effect of voluntary withholding to the purposes of "this chapter and so much of subtitle F as relates to this chapter". This limitation thus provides that the direction by a Social Security benefit recipient to withhold is solely for the purpose of application of the amounts withheld to federal income tax liabilities, and it goes no further. Thus, an individual who elects withholding of Social Security benefits pursuant to § 3402(p)

cannot contend that the Internal Revenue Service has violated 42 U.S.C. § 407. However, by the clear language of 26 U.S.C. § 3402(p)(1), the election to withhold benefits only the Internal Revenue Service, and does not constitute a general waiver of the protections of § 407(a) with respect to Social Security benefits *vis-a-vis* other entities.

The Trustee cites *In re Garrett*, 225 B.R. 301 (Bankr. W.D.N.Y. 1998) in support of his argument. This case is inapposite. The case involves issues relating to New York State real property tax credits, dependent and child care credits, and earned income credits; and earned income credits under federal law. The court determined that no exemption law of the State of New York applied to any of these credits. Social Security benefits were not involved at all in this case.

Finally, the Trustee cites to something designated as "*Re Virgin*, 2004 WL 496031 (Bankr. Idaho)". When the court designated the Trustee's citation in the "Find this Document by Citation" in WESTLAW, the sole response to the query was "2004 UT H.B. 292 (SN)", a bill in the Utah Legislature which apparently deals with motorcycles, motor-driven cycles, and mopeds as being covered by the "Powersport Vehicle Franchise Act". Punching in the WESTLAW cite provided by the Trustee is as far as the court will go in seeking to find the authority upon which the Trustee relies. It is strongly suggested that when a party before the court cites to a case other than one in a standard reporting service, the party attach the case as part of an appendix to the party's legal memorandum.

The Social Security laws of the United States of America have since their inception provided a "safety net" and/or a source of retirement income to persons eligible to receive benefits. Many persons who receive Social Security disability payments have no other source, or limited sources, of income apart from those benefits, and those benefits in many instances provide the only means by which recipients can obtain the necessaries of life. The same is true to a lesser extent for Social Security retirement benefits, but again, it is beyond question that a

significant percentage of recipients of benefits in this category require those benefits for provision of the necessaries of life. The obvious purpose of 42 U.S.C. § 407 is to insulate these benefits from the claims of creditors, as stated in *Mason v. Sybinski*, 280 F.3rd 788, 793 (7th Cir. 2002):

> The rationale behind the anti-attachment provision is to "protect social security beneficiaries and their dependents from the claims of creditors." *Fetterusso v. New York,* 898 F.2d 322, 327 (2d Cir.1990).

In the context of a Chapter 7 bankruptcy case, the Trustee seeks to collect assets of the debtor available for distribution to creditors under applicable law. In the context of Social Security benefits, no general creditor could reach a debtor's Social Security benefits. Thus, although those benefits may be deposited in a bank account [a form of intangible property under most states' laws, and definitely under Indiana's laws, for the purposes of 11 U.S.C. § 541(a)], Social Security benefits are immune from attachment by creditors even if transformed into the debtor/ creditor relationship of a bank account. The concept of transformation of Social Security benefits into another form of property such as a bank account, and the concept of transformation of benefits into a federal tax refund, are parallel. The preclusion of creditors reaching the former also precludes creditors from reaching the latter. Moreover, as clearly provided by 42 U.S.C. § 407(c) and 26 U.S.C. § 3402(p)(1)(C)(I), transformation of Social Security benefits into a tax payment are solely for the benefit of the Internal Revenue Service.

In the instant case, there is no question that the entirety of the "tax refund" which the Trustee seeks to reach by his motion for turnover derives from Social Security benefits. The court determines that the nature of the payments received by the debtor in the form of an ostensible "refund" by the Internal Revenue Service was a "Social Security benefit" as defined by 26 U.S.C. § 3402(p)(1)(C)(I), and that, as such, the payment did not lose the protection of 42 U.S.C. § 407(a). Moreover, that statute specifically provides that Social Security benefits "paid

or payable" are not subject "to the operation of any bankruptcy or insolvency law". As a result, the payment for which the Trustee seeks turnover is exempt, and is not subject to turnover under 11 U.S.C. § 542(a).

IT IS ORDERED, ADJUDGED AND DECREED that the Trustee's Motion for Turnover filed on March 6, 2009 is denied.

Dated at Hammond, Indiana on September 30, 2009.

/s/ J. Philip Klingeberger
J. Philip Klingeberger, Judge
United States Bankruptcy Court

Distribution:
Debtor, Attorney for Debtor
Trustee, US Trustee